

THE RAILROAD RETIREMENT SYSTEM:
BENEFITS AND FINANCING

Congress of the United States
Congressional Budget Office

NOTES

For estimating purposes, annual appropriations for "windfall" railroad retirement benefits (see page 7) are assumed to remain constant at \$350 million. A continuing resolution, enacted on December 15, 1981, provided federal funding through March 31, 1982 and increased the 1982 appropriation to the Railroad Retirement System from \$350 million to \$379 million.

Unless otherwise specified, all dates in this paper refer to fiscal years.

In some tables, details may not add to totals because of rounding.

PREFACE

This paper, undertaken at the request of the Senate Committee on Labor and Human Resources, examines the benefits and finances of the Railroad Retirement System. Particular attention has been given to the differences between railroad retirement annuities and those typically available other private-sector employees. In keeping with CBO's mandate to provide objective and nonpartisan analysis, the study makes no recommendations.

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SUMMARY

The Railroad Retirement System (RRS), unlike any other pension plan covering private-sector employees, has provisions set by federal statute and is administered by the U.S. government. Thus, changes in RRS benefits or finances affect the federal budget. The RRS, which currently provides mandatory pension coverage for employees of approximately 1,000 railroad companies, requires annual outlays of some \$5.7 billion. At present, about 500,000 railroad workers and their employers support nearly one million beneficiaries, of whom something over half are spouses and survivors.

Since the inception of the system in 1935 (that is, before the establishment of Social Security), the Congress has repeatedly revised RRS benefits and financial provisions. The most recent statutory amendments, enacted in the summer of 1981, raised the total RRS taxes that partially finance the system from about 19 percent to some 22 percent of total payroll; they also modified benefits and authorized the RRS to borrow from the general fund of the U.S. Treasury. Without the 1981 legislation, the RRS program would have become insolvent by 1985. But as amended, the system should maintain a positive financial condition through 1990 provided employment in the industry does not decline precipitously.

HOW THE SYSTEM WORKS

Today, RRS remains independent of the Social Security program, although the two systems now have many common features and do coordinate coverage. In 1975, the RRS was restructured to resemble the two-part retirement available to most private-sector employees: a Tier I component that not only substitutes for Social Security but also provides extra benefits; and a corporate-type component, Tier II, which in some instances may be augmented by a longevity supplement and a "windfall," or dual, payment earned by nonrailroad employment prior to 1975.

About 62 percent of RRS revenues come from the payroll taxes that railroad employees and employers pay, and about 28 percent

come from a transfer payment from Social Security. (The intent of the transfer payment was to assure that neither the RRS nor the Social Security program is better or worse off financially because of their independence. The transfer currently works to the advantage of RRS, because past declines in railroad employment have resulted in smaller payroll tax revenues to support Social Security-type benefits now being paid by RRS.) The remaining RRS revenue comes mainly from interest and federal appropriations, which finance windfall payments.

FINANCIAL CONDITION AND CONTINGENCY MEASURES

The solvency of the RRS remains the subject of some concern because, even with the 1981 amendments, RRS reserves will drop from \$1.94 billion to \$1.88 billion during 1982. Uncertainties limit the accuracy of any projections, but the future condition of the RRS will depend generally on the revenues collected from payroll taxes and in turn, on the level of railroad employment. Statistical analysis indicates that, during the past 20 years, railroad employment has been directly correlated with changes in real Gross National Product (GNP). Most current economic projections predict some annual growth in the real GNP.

The Congressional Budget Office currently assumes (somewhat optimistically) that the economy will grow at an average annual rate of 3.5 percent through 1987. If this growth materializes, RRS reserves will accumulate in 1983 and subsequent years, reaching an estimated \$2.4 billion in 1987, or 33 percent of the year's RRS outlays. Under less optimistic economic assumptions, projected levels of railroad employment would be lower and would thus generate less tax receipts. According to actuarial projections prepared by the Railroad Retirement Board, the RRS could face funding problems if, in 1984, employment fell below 450,000. But a drop of this magnitude is not likely, assuming future growth in the nation's economy and a continuation of historical relationships between real GNP and railroad employment. The RRS, however, remains subject to other forces that could reduce program revenues, including technological changes in the transportation industry, amendments to Social Security, labor disruptions, and future declines in the demand for transporting coal.

COMPARISON WITH OTHER PRIVATE-SECTOR RETIREMENT

Railroad retirement includes several benefit provisions that are superior to those commonly available in the rest of the private sector--including:

- o No benefit reduction for career employees retiring as early as age 60;
- o Spouse payments that include a corporate-type benefit component;
- o Tax-exempt status for virtually all RRS benefits; and
- o Guaranteed cost-of-living adjustments.

Considerations of RRS benefit advantages should not overlook the quite high and recently raised payroll withholdings railroad companies and employees pay toward the corporate benefit component. Tier II payroll withholdings have just been raised from 9.5 to 13.75 percent (the employee pays 2 percentage points) of the first \$24,300 of earnings in calendar year 1982.

Taken together, the comparative advantages of RRS help provide married career employees highly attractive income security at relatively early ages of retirement. The initial RRS income for such new annuitants, who represent more than half of those now retiring directly from the railroads, could easily exceed the net annual salary received just before retirement. Largely because of early-retirement provisions and Tier II spouse payments, railroad retirement offers benefits to married annuitants that appear among the highest in private industry. This point becomes particularly clear when expressed in terms of after-tax wage replacement. For a married worker retiring with an annual salary of \$22,000, RRS provides a net wage replacement of 129 percent; the RRS wage replacement of a \$30,000 salary is 105 percent. These rates exceed those available under retirement plans, reviewed by CBO, in the utilities and other transportation industries.

ALTERNATIVE BENEFIT PROVISIONS

The Congress may want to consider modifying RRS as a means to fortify further the program's financial condition, to reduce

federal budgetary costs, or to align the RRS better with typical private-sector practices. Because of the increased RRS tax burden already imposed and the link to future scheduled increases in Social Security taxes, any modifications to the current system would most likely entail benefit reductions rather than additional tax increases.

The arguments for and against maintaining the current system and three possible modifications are outlined below. (The alternatives are based on the assumption that the federal role in RRS will not change radically, although some proposals to withdraw most or some of the government's involvement in RRS have been advanced.) Options II and IV go beyond the adoption of private-sector practices in order to demonstrate the maximum budgetary effect possible. For estimating purposes, all of the options are assumed to have an October 1982 effective date. As a practical matter, the timing and duration could differ, and the Congress could mix or adapt the measures to fulfill specific reduction objectives. The three alternatives could generate five-year savings ranging from \$0.1 billion to \$1.9 billion (see Summary Table).

Option I: Continue the Current System

Advocates of the current system point out that the Congress recently enacted changes to assure adequate finances for the RRS. Opponents argue that the system's payroll taxes, already representing 22 percent of payroll, support a program that provides excessive benefits to many new annuitants.

Option II: Reduce Benefits for Early Retirement

Under this option, career employees who spent 30 or more years with the railroads could still retire as early as age 60, but primary and spouse benefits would be reduced by the same age factors that apply to Social Security. As a result, some 10,000 employees per year would either receive lower benefits or delay retirement. Cumulative savings during the first five years would total \$0.7 billion. (Such an early-retirement reduction proposal would probably carry certain retroactive provisions; otherwise, RRS costs would rise sharply as employees accelerated retirement plans to avoid scheduled benefit cuts.)

In light of proposals to increase Social Security's early-retirement reductions, some observers might view Option II as not

going far enough. Others would criticize it because many railroad workers have already made plans for early retirement. In some cases, however, early-retirement annuities available under Option II would continue to exceed after-tax income from active railroad employment.

Option III: Reduce Tier II Spouse Benefits

Option III would automatically achieve savings by suspending the annual cost-of-living increases in Tier II spouse payments, excluding survivor benefits. This would recognize the unique benefit advantage available to married RRS retirees and avoid reductions both in the initial annuities awarded new retirees and in present payments to current annuitants. Option III would also bring Tier II survivor provisions into closer alignment with retirement practices in the rest of the private sector. Cumulative savings through 1987 could reach \$120 million.

In order to provide spouse survivor protection, most private-sector retirees must accept an actuarial reduction in their initial annuities. Option III would apply the more modest offset currently in effect for federal civilian retirees (2 1/2 percent of the first \$3,600 plus 10 percent of the remaining annual annuity).

Opponents of Option III would point out that spouse and survivor benefits were revised as part of the 1981 railroad amendments and that further revisions would breach standing agreements between labor and management. Single and widowed employee annuitants could argue, however, that an individual's marital status should not influence the size of a corporate pension. From their perspective, Option III should further limit spouse benefits as a means to increase the railroad employee's annuity.

Option IV: Tax Railroad Retirement Benefits

This alternative would reduce federal costs for RRS by increasing income tax receipts at the expense of railroad annuitants. First-year savings would equal some \$360 million and would accumulate to about \$1.9 billion over five years.

Railroad annuitants would object to Option IV because the typical private-sector retiree receives tax-exempt Social Security benefits. But this approach would allocate the financial loss according to total taxable income. Railroad annuitants most able

to accommodate the reduction would likely bear the greatest burden, and low-income annuitants would be liable for little if any of the new tax.

The Congress could continue the tax exemption for half of the RRS benefits as an approximation of the Social Security tax exclusion available to other private-sector annuitants. This more limited action could be viewed as sound public policy, regardless of RRS financial considerations.

SUMMARY TABLE. SAVINGS UNDER ALTERNATIVE MODIFICATIONS TO RAILROAD RETIREMENT: DOLLARS IN BILLIONS

	First- Year Savings	Cumulative Five- Year Savings
Reduce Benefits for Early Retirement (Option II)	0.11	0.71
Reduce Tier II Spouse Benefits (Option III)	0.02	0.12
Tax Railroad Retirement Benefits (Option III)	0.36	1.90

SOURCE: Congressional Budget Office.

NOTE: For estimating purposes, the options are assumed to take effect October 1, 1982.

Several features distinguish the Railroad Retirement System (RRS) as unique. First, RRS is the only pension plan for private-sector workers in the United States that is managed by the federal government. Second, it is the only pension system that offers annuitants retirement incomes that are essentially tax free. Third, it treats all workers in a given industry, regardless of what specific firms employ them, as a single body; common practice in other private industries is that pension plans are negotiated by labor and management on a firm-by-firm or regional basis. Partly because of these peculiarities, RRS is a subject of widespread interest and specifically, of governmental concern for both the Executive and the Legislative branches.

The industry-wide RRS now covers the employees of some 1,000 railroad companies and awards age and disability pensions for retired employees, payments for their spouses, and survivor benefits. At present, the RRS provides mandatory pension coverage for about 500,000 active workers and nearly one million annuitants. Fewer than half of the RRS annuitants are in fact former railroad employees--55 percent being spouses or survivors. During the next 10 years, the number of railroad employees added to the retirement rolls will decline, averaging about 21,700 a year through 1986 and averaging about 17,000 each year thereafter. The total number of annuitants will also decline because new RRS beneficiaries will not offset the deaths of present retirees and survivors.

Direct costs for railroad retirement have been rising steadily. For instance, annual RRS outlays have grown from \$1.6 billion in 1970 to \$5.4 billion in 1981. This year, the program will disburse some \$5.7 billion in annuity benefits and related costs. By 1987, outlays will reach \$7.4 billion. ^{1/} Nearly all of that projected increase will result from cost-of-living provisions, which automatically adjust RRS benefits for inflation.

^{1/} Outlay projections were developed by the Railroad Retirement Board at the request of the Congressional Budget Office.

From its inception during the Depression, the RRS has faced one financial crisis after another. On the basis of recommendations from labor and management, the Congress has revised the program again and again. The most recent statutory amendments, enacted in the summer of 1981, were necessary to avert RRS' insolvency. The Economic Recovery Tax Act of 1981 significantly increased RRS payroll withholding tax rates, and the Omnibus Reconciliation Act of 1981 modified several railroad retirement benefit provisions and authorized borrowing by RRS from the general fund of the U.S. Treasury. (Appendix A summarizes the changes in railroad benefits resulting from the 1981 amendments.) The 1981 reconciliation legislation also requires the President, by October 1, 1982, to submit to the Congress a report that analyzes the long-run financial condition of the RRS and options for assuring its actuarial soundness.

The RRS program's past financial difficulties and recent cost trends have given rise to three particular concerns: the adequacy of current RRS financing; the cost impact on the federal government; and whether or not RRS benefits and costs should be reduced. In response to these concerns, this paper provides background information for examining the current railroad retirement program as revised by the 1981 legislation. (The relationship of RRS to unemployment insurance and RRS disability benefits are not discussed because neither has much impact on RRS's long-range fiscal requirements.) In particular, this study addresses the following questions:

- o Do current financing provisions ensure adequate income for the program?
- o To what extent could changes in RRS reduce the federal budget?
- o Are existing benefits excessive, in view of retirement practices in the rest of the private sector?

The remainder of this chapter presents an overview of the current system--its mechanics, the benefits it provides, its sources of revenue, and contingency measures to safeguard it against future financial difficulties. Chapter II analyzes RRS financing and cost issues; and Chapter III describes possible modifications to the current system that would reduce the federal budget by adjustments in RRS benefits.

HOW THE BENEFIT PROVISIONS WORK

The Congress enacted the Railroad Retirement System in 1935--before the introduction of Social Security--to substitute for the failing pension plans of railroad companies, to encourage older workers to retire, and thereby, to provide jobs for younger workers. Social Security and RRS remain independent today, although the two systems now have many common features, and they do coordinate coverage and financing.

In 1951, the Congress established a funding mechanism whereby neither the Social Security program nor the RRS would be better or worse off because of their independence. Since that time, an annual calculation has determined the payroll taxes that would have been collected and the benefits that would have been paid if railroad employment were covered by Social Security. The first calculation was retrospective, encompassing railroad employment between 1937 and 1951. Now the estimated annual difference between the prior fiscal years' tax receipts and benefit payments is transferred, each June, from Social Security to RRS. 2/

The Two-Tier Benefit System

Since 1975, railroad retirement has been structured after the two-part retirement income available to other employees in the private sector: an annuity component--Tier I--that both substitutes for Social Security coverage and provides certain extra benefits; and a corporate-type component, Tier II. The Tier I component accounts for about 64 percent of the total amount of RRS outlays, and Tier II accounts for roughly 27 percent. Most of the remaining costs cover two relatively small, special RRS benefits: longevity supplements for particularly long careers of service, and so-called "windfall," or dual, payments for annuitants with prior service in nonrailroad work covered by Social Security (discussed below). Table 1 presents the various benefit components of RRS.

The sum total of these benefit components can amount to a distinctly generous pension. For the typical male railroad worker

2/ See General Accounting Office, Keeping the Railroad Retirement Program on Track--Government and Railroads Should Clarify Roles and Responsibilities (March 9, 1981) pp. 8-13.

TABLE 1. BREAKDOWN OF RAILROAD RETIREMENT BENEFITS AND OUTLAYS:
FISCAL YEAR 1982, DOLLARS IN BILLIONS

Benefit Component	Source of Financing	Cost As Percent of Total	Cost in Billions of Dollars
<hr/>			
Tier I			
Social Security substitute	Employer and employee withholdings on payroll (10.8 percent) <u>a/</u> plus transfer payments from Social Security	59	3.33
Extra benefits for career employees and their dependents	Derived from Tier II taxes	5	0.28
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Tier II	Employer and employee withholdings on payroll (13.75 percent) <u>a/</u>	27	1.54
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Longevity Supplement	Employer contribution for each employee hour worked	2	0.12
Windfall Payment	Federal appropriations <u>b/</u>	6	0.35
<hr/>			
Total <u>c/</u>		100	5.68
<hr/>			

SOURCE: Congressional Budget Office.

a/ Beginning in January 1982, RRS taxes will be levied on the first \$32,400 of railroad earnings for Tier I withholdings and on the first \$24,300 for Tier II withholdings.

b/ Recent action on the 1982 appropriation for RRS will increase windfall funding somewhat above the \$350 million estimate.

c/ Details do not add to totals because administrative expenses are excluded.

retiring in January 1983 (see Example), the two-tier RRS pension may significantly exceed his after-tax wage income just before railroad retirement. In fact, his retirement income can be as much as 29 percent again as large as his highest net earnings during his working life.

To help finance these benefits, the combined employer and employee withholdings, in 1982, will total nearly 22 percent of total payroll. The individual RRS benefit provisions and sources of financing are described in more detail in the following sections.

Tier I Benefits. These benefits are based on combined railroad and Social Security covered wages and then reduced for any Social Security benefit received. Besides substituting for Social Security coverage, Tier I has another feature that enhances RRS pensions. Specifically, employees with the equivalent of 30 or more years of railroad service may retire as early as age 60 with no reduction in employee or spouse benefits. This is distinct from Social Security benefits, which are reduced by 1/180 for each month the retiree is under age 65, by 1/144 for each month the spouse is under 65, and which are not available at all until age 62.

Tier II Benefits. Benefits for this component are now determined by the highest average monthly salary received over any five-year period and by total length of railroad service, which includes credit for certain military duty. ^{3/} The percentage of average salary received as a pension rises by 0.7 percentage points for each year of service. This amount is increased if the annuitant is married (Tier II spouse benefits), but it is decreased if the annuitant receives a windfall benefit.

Longevity Supplements. Beginning in 1966, the RRS provided a supplemental annuity to employees with the equivalent of 25 or more years of railroad service. If an annuitant has 30 or more years of service, he may receive the longevity supplement immediately upon retirement; otherwise, he receives it upon reaching age 65. Roughly 75 percent of employees now retiring directly from the railroad industry receive a longevity supplement.

For employees who retired before 1974, the monthly supplemental payment could reach a maximum of \$70 (\$840 per year) but

^{3/} Military service occurring during war or national emergency and immediately preceded by railroad employment applies toward the calculation of railroad retirement benefits.

EXAMPLE OF TWO RRS RETIREES' PENSIONS (January 1983)

To illustrate the composition and possible sizes of RRS pensions, CBO has constructed two hypothetical railroad retirees and their RRS benefit packages. Retiree A, a widower, elects to begin collecting RRS benefits at age 62 and at a final gross salary of \$30,000; he has 23 years of railroad service as well as other employment covered by Social Security. Retiree B, whose wife is still living, retires at age 62, after 36 years of railroad service; his final gross salary was also \$30,000.

	<u>Retiree A</u>	<u>Retiree B</u>
Tier I Social Security substitute	\$ 6,110	\$ 8,970
Tier I extra benefit for early retirement	--	3,630
Tier II corporate-type benefit	3,030	7,410
Tier II longevity supplement	none	510
Windfall payment	<u>\$ 1,210</u>	<u>\$ 610 a/</u>
Total RRS pension	\$10,350	\$21,130
<hr/>		
RRS pension as a percent of final gross salary	(34%)	(70%)
RRS pension as a percent of final salary after taxes	(60%)	(105%)

a/ Less than half of new railroad annuitants with more than 30 years of service receive windfall benefits. Excluding the \$610 payment would reduce this retiree's after-tax replacement rate from 105 percent to 103 percent.

required a reduction in the regular railroad annuity. For more recent retirees, the monthly maximum was reduced to \$43 (\$516 per year) and the annuity offset was discontinued. ^{4/} The 1981 amendments eliminated the supplemental annuity for all workers first hired by the railroads after October 1, 1981.

Windfall or Dual Benefits. Before 1975, railroad retirement and Social Security were not coordinated, and employees who had worked under both systems could gain an extra benefit advantage. (Social Security benefit calculations assured higher wage replacement for low-income annuitants but did not distinguish noncareer workers with 10 years of coverage from career workers with long years of service at low wages.) The coordination of RRS and Social Security coverage in 1974 corrected this anomaly for subsequent employment, but the provision was not retroactive in that it did not eliminate any extra benefit advantage already acquired. Thus, railroad employees with the equivalent of 10 years' coverage under both Social Security and the RRS prior to 1975 may receive the special windfall (or dual) payment. ^{5/}

In 1974, the Congress agreed to subsidize windfall benefits through annual appropriations to the RRS. But the 1981 Omnibus Reconciliation Act requires the Railroad Retirement Board to reduce windfall benefits if the estimated aggregate payments exceed the total amount appropriated. Because the estimated payments for 1982 exceed the federal funds currently available, the board has cut individual windfall benefits. ^{6/}

^{4/} The calculation of longevity supplementals for employees hired since 1974 includes a minimum of \$23 per month plus \$4 per month for each year of service over 25 up to a maximum of \$43 per month.

^{5/} Windfall payments represent the benefits acquired prior to 1975 under both Social Security and railroad retirement, minus the smaller benefit that would have been earned if railroad earnings were integrated with Social Security earnings. For a detailed discussion of windfall benefits, see General Accounting Office, Keeping Railroad Retirement on Track, pp. 25-37.

^{6/} The Congress has enacted three resolutions that continue federal appropriations for 1982. The current resolution, in effect from December 15, 1981 through March 31, 1982, provides \$379 million for windfall benefits and thus requires an average benefit reduction of some 14 percent.

RRS PENSIONS AS WAGE REPLACEMENT

As stated above, the combination of current RRS features can, under certain circumstances, offer attractive retirement income, especially to married employees who spend a major part of their working years with the railroad industry. Such employees, representing more than half of workers who become eligible to retire directly from the railroads on the basis of age and length of service, could receive monthly benefits that greatly exceed after-tax wages just before retirement.

Calculating the portion of after-tax earnings continued at retirement--referred to as wage replacement--serves as a way to assess the combined impact of RRS benefits. To illustrate the income redistribution aspects of benefits and taxes, the Congressional Budget Office has calculated wage replacement rates at two different gross final salary levels: \$22,000 and \$30,000. 7/ Under current law, RRS replaces, respectively, 129 percent and 105 percent of railroad wages before retirement and after taxes. 8/

The RRS wage replacement rates would be much less attractive were it not for three particular provisions: that RRS makes no reduction in Tier I benefits for retirement as early as age 60, that it offers additional payments to retirees with living spouses (Tier II spouse payments), and that nearly all RRS benefits are tax free. The effects of these three provisions are illustrated on the following page:

7/ These income levels were selected after analyzing age and wage data on railroad employees with 29 or more years of service.

8/ Unless otherwise stated, the wage replacement calculations for RRS and other plans, which appear in Chapter II, assume retirement in January 1983 at age 62 (the earliest age at which a retiree may receive Social Security); 36 years of service (consistent with RRS experience); wage history based on 5 percent annual growth; and RRS taxes and benefits that will be in effect on December 31, 1981. The calculations for RRS benefits further assume that the annuitant receives both a longevity supplement and a windfall payment. The calculations reflect the reduced federal income tax rates enacted by the Congress in 1981 and state income tax rates of Colorado.

	Percent of Net Wages Replaced by RRS	
	Final Gross Salary of \$22,000	Final Gross Salary of \$30,000
With all existing benefits	129	105
Without early retirement benefits	110	87
Without Tier II spouse payments	115	93
Without income tax exclusions	119	96
With the three omissions above	93	73

With any one of the provisions eliminated, RRS benefits for married employees would drop significantly. But they would still compare favorably with after-tax income available from other private-sector plans (see Chapter II, page 26). Without all three provisions, RRS benefits for married annuitants would drop substantially. As the examples above demonstrate, the wage replacement rates would decline from 129 percent to 93 percent for the \$22,000 gross salary level, and from 105 percent to 73 percent for the \$30,000 level.

SOURCES OF RRS REVENUES

The RRS currently receives about 62 percent of its program revenues from payroll taxes paid by railroad employees and employers and about 28 percent from the transfer payment from the Social Security system. During the next 10 years, the relative value of employer and employee contributions will gain importance over the Social Security transfer (see Table 2). The remaining income derives mainly from interest and the appropriation of federal funds for windfall (or dual) benefits. The federal government further supports the RRS program in two ways: through new authority, enacted in 1981, to borrow from the general fund of the U.S. Treasury, and by exempting benefits from federal income taxes (the latter provision is described in greater detail in Chapter II).

TABLE 2. SOURCES OF RAILROAD RETIREMENT FINANCING: 1982 AND 1990

	Dollar Amounts (in billions)		Percent of Total Revenue	
	1982	1990	1982	1990
Employer Contributions				
Social Security-Type				
Tier I Taxes	0.88	1.71	15.7	19.4
Corporate-Type				
Tier II Taxes	1.33	2.36	23.8	26.8
Special Length-of-Service Supplement	0.16	0.17	2.8	1.9
Subtotal	(2.37)	(4.24)	(42.3)	(48.2)
Employee Contributions				
Social Security-Type				
Tier I Taxes	0.88	1.71	15.7	19.4
Corporate-Type				
Tier II Taxes	0.21	0.40	3.8	4.5
Subtotal	(1.09)	(2.11)	(19.5)	(24.0)
Transfer Payments from Social Security	1.59	1.92	28.4	21.8
Federal Appropriations <u>a/</u>	0.35	0.35	6.2	4.0
Interest & Other	<u>0.20</u>	<u>0.18</u>	<u>3.6</u>	<u>2.0</u>
TOTAL	5.60	8.80	100.0	100.0

SOURCE: Derived from estimates prepared by the Railroad Retirement Board's Bureau of Research, according to economic assumptions of the Congressional Budget Office.

NOTE: Details may not add to totals because of rounding.

a/ For estimating purposes, annual appropriations for windfall benefits are assumed to remain constant at \$350 million.

Payroll Taxes

Railroad retirement payroll taxes are structured after the RRS's two-part benefit program, although the revenues are not earmarked by benefit component. For railroad employees as a group, the combined employer and employee withholdings for RRS, in 1982, will total 21.8 percent of total payroll, of which 15.3 percent of total payroll is paid by the employer (see Table 3).

The RRS payroll taxes for Tier I are linked to those levied for Social Security. 9/ Thus, increases in both the Social Security tax rates and the maximum income subject to taxation will cause equivalent adjustments in RRS Tier I taxes. 10/ In January 1982, employers and employees will each pay 5.4 percent (if the portion for Medicare coverage is excluded) on earnings up to a maximum annual amount of \$32,400.

For the Tier II component, RRS payroll taxes are now independent of Social Security and will apply, in calendar year 1982, to earnings up to the annual equivalent of \$24,300. 11/ In October 1981, Tier II taxes rose from 9.5 percent to 13.75 percent of covered payroll. In particular, the Tier II taxes levied on the railroad companies (that is, the employers' share) increased from 9.5 percent to 11.75 percent, and employees began contributing 2.0 percent of pay. An additional tax, equivalent to \$0.17 for each employee hour worked in calendar year 1982 and maintained in a separate account, is also paid by employers to finance the special length-of-service supplement.

9/ The difference is that RRS Tier I payroll taxes are calculated on monthly rather than annual earnings. The General Accounting Office has recommended that the RRS calculation conform to the annual method used for Social Security taxes; see Keeping Railroad Retirement on Track, p. 17.

10/ The withholding tax rates and the taxable earnings bases for Social Security are scheduled to rise each year, in accordance with the Social Security Amendments of 1977. These changes will be reflected in the RRS Tier I rates as well.

11/ From 1974 through 1978, Tier II taxes applied to the same monthly income used for calculating taxes for Social Security (Tier I) taxes. Annual increases in the Tier II tax maximum still reflect increases in private sector wage rates.

TABLE 3. SUMMARY OF RRS PAYROLL TAXES IN 1982

	Tier I Social Security Substitute	Tier II	Length-of- Service Supplement	Total
(in dollars)				
Maximum Earnings Subject to Taxation as of January 1982	32,400	24,300	<u>a/</u>	n/a

Tax Rates as a Percent of Covered Payroll				
Employer	5.40	11.75	1.11	18.26 <u>b/</u>
Employee	<u>5.40</u>	<u>2.00</u>	<u>--</u>	<u>7.40 <u>b/</u></u>
Total	10.80	13.75	1.11	25.66 <u>b/</u>
Taxes as a Percent of Total Payroll				
Employer	4.96	9.26	1.11	15.33
Employee	<u>4.96</u>	<u>1.47</u>	<u>--</u>	<u>6.43</u>
Total	9.92	10.73	1.11	21.76

SOURCE: Congressional Budget Office.

a/ Taxes based on \$0.17 for each hour worked by employees.

b/ Totals represent the sum of withholding rates for separate RRS components, which each use a different basis for calculating taxable earnings.

Transfer Payments. Annual transfers between the Social Security trust funds and railroad retirement have become an important source of revenue for the RRS. Through 1990, the RRS will receive an annual payment from Social Security averaging \$1.8 billion; after that, the size of the payment will gradually decline. Some time around the year 2005, Tier I tax revenues are projected to exceed Social Security-type benefits for the first time. In that year, the direction of the transfers should reverse, with RRS making payments to Social Security.

Federal Borrowing. The 1981 amendments authorize the RRS to borrow from the general fund of the U.S. Treasury in anticipation of the annual Social Security transfer. Without such borrowing authority, the RRS could find itself with insufficient cash to pay benefits during the months preceding the June transfers. Under the present provisions, loans to RRS must be repaid, with interest, as soon as RRS funds are available; the outstanding loan may not exceed the next transfer payment from Social Security. 11/

Federal Appropriations. Each year, the federal government appropriates funds for the windfall (or dual) benefits described above for employees who had previously received an advantage from railroad's independence from Social Security. In recent years, federal appropriations have covered less than the amount needed. For example, the 1981 appropriation of \$350 million fell nearly \$100 million short of the total needed for windfall benefit payments; thus, funds had to be diverted from Tier I and Tier II tax collections. The authorization for windfall appropriations does not specify a particular level of funding; but the 1981 amendments limit aggregate windfall disbursements to the level of federal funds available.

FINANCIAL CONTINGENCY ACTIONS

In addition to the Presidential report on RRS required next year, the 1981 amendments include several contingency provisions designed to safeguard the system against future financial failure and to assure payment of benefits at least equivalent to the Social Security portion of Tier I payments. The Congress stipulated that such minimum RRS benefits shall be provided even if paid directly from the Social Security trust fund, although further legislative action might be necessitated.

11/ Social Security's annual payments to RRS are drawn from both the Old Age and Survivors Insurance and the Disability Insurance trust funds. RRS borrowing has no direct impact on federal budget outlays, because the loans and repayments represent internal budgetary transactions between the general fund of the U.S. Treasury and the Railroad Retirement Trust Fund.

The contingency measures are triggered whenever the Railroad Retirement Board projects that half of a given year's federal borrowing authority will be used up. When this happens, the board must report to the President and the Congress the status of borrowing, recommended funding changes, and the year in which, without remedial funding, benefits would need to be reduced. Within 180 days after submission of the board's report, three separate steps must be taken: labor and management must report their joint or separate recommendations to the President and the Congress; the President must submit recommendations to Congress to insure payments equivalent to Social Security benefits; and the Railroad Retirement Board must issue regulations to implement benefit reductions. The Congress could either develop legislation based on the recommendations submitted or allow the issued regulations to go into effect.

CHAPTER II. RRS ISSUES--SOLVENCY, BUDGETARY COSTS, AND BENEFIT ALIGNMENT

Modifying the railroad retirement system could be considered primarily for two purposes:

- o To reduce federal expenditures, and
- o To bring the benefit structure into closer alignment with other private-sector retirement.

In addition, the solvency of the system remains a subject of concern despite the legislative amendments recently enacted to assure a sound financial base for the program. The first portion of this chapter assesses the adequacy of RRS financing.

THE FINANCIAL CONDITION OF THE RRS TRUST FUND

Without the new legislation enacted in 1981, the railroad retirement program would have been destined to suffer cash flow problems in the spring of 1982 and to become insolvent by 1985. But a series of measures--the increase of withholding rates from 18.6 percent to 21.8 percent of total payroll, the authorization of limited borrowing from the U.S. Treasury, and certain benefit reductions agreed to by both labor and management--was taken to put RRS on a sound financial footing. Nonetheless, the system's financial prospects are still subject to changing conditions in the economy and the transportation industry. In fact, RRS is currently operating at a deficit.

The Railroad Retirement System could face funding problems in the 1980s if a sharp drop in railroad employment occurs. According to RRS actuaries, the financial contingency provisions included in the 1981 legislation could be triggered if railroad employment fell below 450,000 in 1984. ^{1/} In 1981, railroad

^{1/} Letter of July 16, 1981 from the Acting Chief Actuary and Director of Research to the Chairman of the Railroad Retirement Board.

employment averaged 513,000 and the RRS received some \$4.7 billion in revenue--including \$2.7 billion from payroll taxes and a \$1.3 billion transfer from Social Security. Because these revenues were short of the \$5.4 billion paid out for benefits and related expenses, RRS reserves--in one year--fell from \$2.7 billion to \$1.9 billion. Even with the legislated benefit cutbacks and increases in payroll taxes, reserves will drop another \$60 million during 1982. In later years, though, CBO projects (somewhat optimistically) that railroad employment will decline only slightly. Thus, RRS funds will begin to accumulate and could reach 32 percent of annual outlays by the end of 1984 and about 41 percent by the end of 1990. Although more job reductions in the railroad industry would occur under less optimistic economic assumptions, employment is not likely to fall below 450,000 in 1984. Therefore, measures that would enhance long-term solvency through changes in benefit levels or financing do not appear necessary at this time.

Financial Projections. Although railroad employment has steadily declined since World War II--dropping from a peak of 3.0 million in 1945 to 0.5 million in 1980, many analysts believe that major cutbacks in rail service have now run their course. Factors cited as stabilizing influences on the railroad industry include deregulation, mergers among railroad companies, energy efficiency of trains, and transportation of grain and coal. ^{2/} But drops in the demand for hauling coal, as well as protracted labor disputes, have forced railroads to reduce employment in the past and could do so again in future years. In the longer term, technological changes such as the development of a coal slurry could have severe impacts on the railroad industry. Such uncertainties limit the accuracy of future projections based on CBO's or any other economic assumptions. Nevertheless, statistical analysis suggests that the key to a healthy railroad industry is continued growth in the nation's economy. ^{3/}

^{2/} See, for example, Gus Welty, "Outlook for 1981: The Stage Is Set For Recovery, But When?" Railway Age (January 26, 1981).

^{3/} Through a regression analysis by the Congressional Budget Office, the annual levels of railroad employment were shown to be closely correlated with changes in real Gross National Product for the 21-year period 1960-1981.